MINUTES
of the
FIRST MEETING IN 2012
of the
REVENUE STABILIZATION AND TAX POLICY COMMITTEE

June 18, 2012
Room 322, State Capitol
Santa Fe

The first meeting of the Revenue Stabilization and Tax Policy Committee for 2012 was called to order by Representative Edward C. Sandoval, chair, on Monday, June 18, 2012, at 9:42 a.m. in Room 322 of the State Capitol in Santa Fe.

Present
Rep. Edward C. Sandoval, Chair
Sen. Mark L. Boitano
Rep. Donald E. Bratton
Sen. Carlos R. Cisneros
Rep. Anna M. Crook
Sen. Clinton D. Harden, Jr.
Sen. Timothy Z. Jennings, Senate President Pro Tempore
Sen. Gay G. Kernan
Rep. Rodolpho "Rudy" S. Martinez
Sen. Howie C. Morales
Rep. Henry Kiki Saavedra
Sen. John Arthur Smith
Rep. Thomas C. Taylor
Rep. Jim R. Trujillo
Rep. Bob Wooley

Absent
Sen. Tim Eichenberg, Vice Chair
Sen. Timothy M. Keller
Rep. Ben Lujan, Speaker of the House

Designees
Sen. William F. Burt
Sen. Bernadette M. Sanchez
Rep. Luciano "Lucky" Varela

Sen. Rod Adair
Rep. Ray Begaye
Rep. Zachary J. Cook
Rep. Brian F. Egolf, Jr.
Rep. Miguel P. Garcia
Rep. Thomas A. Garcia
Rep. Roberto "Bobby" J. Gonzales
Sen. Eric G. Griego
Sen. Phil A. Griego
Rep. Sandra D. Jeff
Rep. Antonio Lujan
Rep. Antonio "Moe" Maestas

Sen. George K. Munoz
Sen. Steven P. Neville
Rep. Debbie A. Rodella
Sen. Nancy Rodriguez
Sen. John M. Sapien
Sen. William E. Sharer
Rep. James R.J. Strickler
Rep. Don L. Tripp
Sen. Peter Wirth

Staff
Pam Ray, Staff Attorney, Legislative Council Service (LCS)
Ric Gaudet, LCS
Damian Lara, Staff Attorney, LCS
Pam Stokes, Staff Attorney, LCS

Guests
The guest list is in the meeting file.

Handouts
Handouts and other written testimony are in the meeting file.

<u>Monday, June 18</u>

Post-Session Fiscal Review
David Abbey, director, Legislative Finance Committee (LFC), presented the committee with a review of the state's fiscal situation. The legislature and governor enacted a balanced budget for fiscal year 2013, with projected reserves of over nine percent. In addition, significant capital investments were authorized, and agreement was reached on the size and scope of tax cuts. However, many significant unresolved issues remain, including the slow economic growth of the state, the need to improve educational outcomes, state pension fund solvency, Medicaid expansion, funding for road projects and local capital projects, Unemployment Compensation Fund solvency and Lottery Tuition Fund depletion.

Recurring revenue projections for fiscal year 2013 are set at $5.65 billion, which is seven percent lower than the peak revenues in fiscal year 2009. Two-thirds of state revenues are generated from gross receipts and income taxes, with the remaining portion coming from the energy sector, investment revenue and miscellaneous sources. Fiscal year 2013 revenue is projected to be five percent higher than fiscal year 2012 appropriation levels. However, some of this "new money" may be offset by the expiration of public employee pension swaps enacted during the recession. The General Appropriation Act of 2012 allocated 43 percent of total appropriations toward public schools; 20 percent toward Medicaid; 13 percent toward higher education; seven percent toward public safety; and 17 percent toward all other state government functions.

Mr. Abbey discussed several ongoing issues addressed by the legislature in the recent session. Several educational reform initiatives were funded, including $9.4 million for the Pre-K and K-3 Plus programs; $8.5 million for the early reading initiative; $3.5 million for interventions for low-performing schools; $2.5 million for short-cycle assessments; and $1 million to develop a new teacher evaluation system. A new higher education funding formula was developed last year, with more emphasis on educational outcomes. The formula funds outcomes, including increased certification and degree granting, especially in priority work force areas and for financially at-risk students. The new formula also funds faculty workload based on completed coursework, rather than enrollment.

The legislature enacted gross receipts tax (GRT) deductions that will have a negative impact on general fund revenues. In addition, attention needs to be paid to the revenue impact of the high-wage jobs tax credit, which has dramatically increased in the past fiscal year. Mr. Abbey also discussed the need for capital outlay reform, especially regarding statewide versus local projects, and the need for a stable source of transportation project funding.

The solvency of public employee retirement funds continues to be studied. The unfunded accrued actuarial liabilities of the two state-funded retirement funds total $10.8 billion. Increased investment returns on the funds are not sufficient to create solvency. Other changes need to be made, such as reducing the cost-of-living allowance, increasing the minimum age of retirement or closing loopholes.

Finally, Mr. Abbey discussed the solvency of the Unemployment Compensation Fund. One area of concern is the scope of ineffective charges being levied against employers with the most claims. Ineffective charges include charges in which benefits paid out on behalf of an employer exceed the contributions made by that employer. Employers with the most claims have limited incentive to control unemployment costs and are being subsidized by employers at lower rates. The Workforce Solutions Department has reported that under current law, employers will be required to contribute taxes under the highest contribution schedule.

Questions and comments from committee members included the following.

- Does the LFC have any concerns about restrictions on educational funding that are set by the legislature but are not being implemented by the executive? Mr. Abbey said that there was a minor dispute regarding the interpretation of Pre-K funding language. Overall, however, there do not appear to be any significant issues of executive overreach.

- There will be $500 million in federal funds to pay for the expansion of Medicaid. However, the state will be required to cover more of the cost in a few years. A study needs to be performed to examine the availability of health care practitioners who serve Medicaid and Medicare patients.

- Some executive agencies have not been willing to provide information to legislative committees.

- Even with 130,000 new enrollees in the Medicaid system, it appears that New Mexico will still have an uninsured rate of about 20 percent.

- What is the status of the Public Education Department's new teacher evaluation system? Mr. Abbey said that the Legislative Education Study Committee is investigating that new system, which appears to be not aligned with the current statutory evaluation system.

- The state's future liabilities for federally funded programs will probably increase, given the likelihood of federal budget cuts.

2012 Tax Legislation

Tom Clifford, secretary of finance and administration, gave a presentation to the committee on significant tax legislation in the 2012 legislature. The Martinez Administration's budget priorities include sustainable budgets, education reform, competitive tax policies, meeting fundamental needs, protecting public safety and achieving an efficient and accountable government. Since fiscal year 2001, state government spending has increased almost 70 percent. This unsustainable growth rate exceeds the combined growth of the population and inflation of an average of 3.9 percent. However, limited spending growth in fiscal years 2012 and 2013 has meant that the state has been able to maintain its general fund reserves close to 10 percent of appropriations. Any future excess revenue growth should be used for one-time spending needs and tax reform.

Fiscal year 2012 revenue grew by nine percent, compared to the original forecast of 2.3 percent. Oil and gas revenues accounted for about 50 percent of this growth. However, GRT revenue also grew by 7.4 percent, and personal income tax revenues grew by 10 percent.

Several tax measures were passed by the legislature and signed into law. Certain costs for construction-related services and construction equipment leasing are now deductible from gross receipts. Manufacturing inputs that are consumed during the process will be deductible, phased in over a five-year period. To mitigate the impacts of these deductions on small cities and counties, those entities will receive an increased share of revenue-sharing from the state. The fiscal impact to the state of the manufacturing input deduction was underestimated by 100 percent. The new estimate reduces state revenue by $80 million annually.

The legislature enacted pass-through entity withholding reforms to streamline paperwork requirements. Oil and gas remitters can now use federal information returns to comply with the new state requirements. Other pass-through entities will report annually, rather than quarterly, and reporting dates now conform with federal reporting dates.

A veterans employment tax credit was enacted to encourage employers to hire recently discharged veterans. Up to $1,000 of wages can be claimed for veteran employees who were hired as new employees within two years of their discharge. The credit can be claimed for one year for each employee hired.

Several pieces of legislation did not pass the legislature, including bills to:

- simplify taxation on small businesses by exempting them from the GRT if total receipts are less than $50,000;

- provide for a deduction from gross receipts for research and development services sold directly to the United States Department of Defense;

- provide a credit from personal income tax liability for military retirement income, which legislation was aimed at recruitment of a skilled labor force to New Mexico; and

- reform and clarify provisions of the high-wage jobs tax credit.

Two bills were passed by the legislature but vetoed by the governor. The first bill would have required mandatory combined reporting for certain types of large retail establishments. Secretary Clifford said that the entire corporate income tax (CIT) structure needs to be reformed. He said that the governor is open to discussing combined reporting as part of an overall reform of the CIT. The other bill would have allocated a portion of the motor vehicle excise tax to the State Road Fund. Secretary Clifford said that the administration is not opposed to such an idea but that this change would require budget adjustments.

The Taxation and Revenue Department (TRD) wants to implement many administrative reforms, including establishing independent hearing officers, establishing an independent tax ombudsman, applying uniform and more transparent rulemaking, extending filing and protest periods and reforming non-taxable transaction certificate rules to improve predictability for businesses.

Questions and comments from committee members included the following.

- How should the state proceed with the goal of establishing a broad tax base with lower rates? Secretary Clifford said that taxes should be based on consumption, rather than investment. Much of the tax base on consumption has been removed in the past several years.

- Many jobs being created in the state cannot be filled by New Mexico's work force. The state needs to provide much better education to children.

- What will the general fund reserve level be at the end of fiscal year 2012? Secretary Clifford estimated reserve levels will be about 12 percent.

- The legislature and executive should study many of the recommendations made by the Blue Ribbon Tax Reform Commission in 2003.

- Is there an estimate of how much the newly enacted veteran employment tax credit will cost? Secretary Clifford said that the TRD will research that question.

- The capital outlay process needs to be reformed. The committee should examine options for reform, with input from the Department of Finance and Administration (DFA). Secretary Clifford said that the administration wants a better evaluation process for local projects. The Local Government Division of the DFA is currently working with local governments to get better information about their proposed projects.

Organizational Business — Work Plan and Schedule

Ms. Ray, Ms. Stokes and Mr. Lara presented the proposed work plan and schedule for the committee for the 2012 interim. After discussion by committee members and addition of a few items to study, the committee adopted the work plan. In the 2012 interim, the committee will:

1. examine the tax code and all other taxes not compiled in the tax code and discuss each tax based on sound tax policy principles and the contribution to state revenue made by each tax;

2. review the revenue status of the state, examine current revenue sources and discuss changes to revenue sources to ensure adequacy of revenue, including tax preparation fraud and the effectiveness of TRD oversight and enforcement of tax collection;

3. review the effectiveness and value to the state of tax incentives, suggest changes to achieve state goals, including the benefits of transferability of income tax credits, and observe progress on projects benefiting from tax incentives;

4. examine the effect of expanded deductions for manufacturing consumables and construction on the stability of revenues of local governments and review the impact of hold harmless provisions to ameliorate the negative impact to local revenues of gross receipts deductions;

5. review trends in state investment earnings, including trends in the balances of the Severance Tax Permanent Fund and the land grant permanent funds, review the Utah proposal on federal royalty distribution and review the revenue received by the state from gaming within the state and the progress of tribal-state gaming negotiations;

6. review the capital outlay process, the balances remaining in outstanding projects and the estimates of funds previously appropriated and available for future projects, and discuss proposed changes to improve the process; and

7. determine legislative actions necessary to implement changes identified by committee members that will improve the tax system in New Mexico.

High-Wage Jobs Tax Credit Issues

Debra Inman, vice president, Albuquerque Economic Development, John Tysseling, chief economist, TRD, and Secretary Clifford discussed with the committee the high-wage jobs tax credit. Ms. Inman began by discussing the importance of the credit for attracting employers to the state and provided some recommendations for making the credit more cost-effective. The credit is considered one of New Mexico's premier incentives for recruiting new businesses. She mentioned the recent creation of 900 jobs in Albuquerque as a result of the credit at Lowe's, Bendix/King, Tempur-Pedic and General Mills. A group of business development organizations has met with executive agency representatives to discuss how the tax credit provisions can be reformed, without reducing the attractiveness of the incentive. Several important cleanup items have been identified, including the need to define "wages", increase the eligible wage rate for urban areas, clarify the definition of "eligible employer", limit the amount of time a company can apply for approval of the credit and extend the expiration date of the credit. Ms. Inman said that the legislature should avoid placing a cap on the amount of tax credit available. That would create uncertainty around the availability of the credit and cause companies to discount the credit when comparing incentives among states.

Mr. Tysseling gave an overview of the high-wage jobs tax credit and its recent fiscal impact. The credit can be claimed against 10 percent of qualified wages for new jobs. A high wage is defined as more than $40,000 annually in urban areas and $28,000 in rural areas. The new job must be eligible for the Job Training Incentive Program or the business must make more than 50 percent of its sales outside New Mexico in order to qualify for the credit. From fiscal year 2006 to fiscal year 2011, the amount of credit claimed ranged from $700,000 to $14 million, averaging $5.7 million. However, in fiscal year 2012, the fiscal impact of the credit is expected to top $48 million.

In fiscal years 2011 and 2012, most of the credits approved by the TRD have been awarded to a few companies. About 30 percent of the claims approved in those years were from job creations more than two years prior to the application for the credit. Data from the applications for the credit suggest that approximately 3,000 new jobs were created that qualified for the credit in the past two fiscal years.

Mr. Tysseling said that the TRD is concerned that a company may claim the credit after a merger, with the "new" jobs from the absorbed company being claimed for the credit. Another concern is that once New Mexico emerges from the current recession, there could be a huge increase in the amount of credit claims.

Secretary Clifford said that the mergers of two companies should not constitute the creation of new jobs. He also said that, currently, the high-wage jobs tax credit can be claimed in addition to other credits or incentives for the same job.

Questions and comments from committee members included the following.

- The working group that is currently looking at ways to reform the high-wage jobs tax credit should have included legislators. Ms. Inman was requested to include legislators who have recently introduced legislation on the subject in the group's future meetings.

- Did the TRD establish clear rules regarding the approval process for the credit? Mr. Tysseling said that the language in statute does not allow the TRD to restrict the definition of "wages".

- Why was there such a huge increase in claims for the credit in fiscal year 2012? Mr. Tysseling said that there are several consulting firms that have been recently marketing the availability of the credit to their business clients.

- It might be a bad idea to grant the credit in rural areas with such a low wage threshold, as that could attract undesirable industries to an area. Mr. Tysseling said that, currently, there is very little use of the credit in rural areas.

Ernst & Young Business Tax Burden Study

Richard Anklam, president and executive director, New Mexico Tax Research Institute, presented to the committee the final report of the update to the Ernst & Young Business Competitiveness Study. The Council on State Taxation (COST) commissioned a study with the accounting firm Ernst & Young to determine the state rankings of a hypothetical investment in each state. The study looked at the effective tax rate and return on investment after 30 years. In that study, New Mexico ranked last. The main reasons for the poor ranking were that the state taxes corporations higher than average, it uses an equally weighted income apportionment formula and nearly all business services are subject to the GRT. Mr. Anklam said that the COST study, like other previous tax-burden studies, did not account for state incentives. Taking into account incentives the state provides would improve New Mexico's ranking.

A coalition of New Mexico private- and public-sector entities decided to fund a more thorough study, comparing New Mexico to several surrounding states, taking into account other factors besides tax burden. The coalition engaged Ernst & Young to expand on the previous study, but limit the scope of the study to eight surrounding states. The study accounted for incentives in the tax calculations and added more industries in the scope of the study. The study estimated the impacts of several policy options on the state's competitiveness, including changing the GRT or CIT, providing GRT deductions for manufacturing inputs and services, allowing for single- and double-weighted sales factor elections for calculating corporate income and providing a GRT deduction on manufacturing equipment.

The results of the new study ranked New Mexico favorably compared to eight other states, after incentives were accounted for. Across all industries, New Mexico had the fourth-lowest effective tax rate. For the service sector, New Mexico had the second-lowest rate, but the manufacturing sector had the third-highest rate. Across all industries, the average effective tax rate for businesses was 6.0 percent. The study looked at how changes in tax laws would affect New Mexico's ranking, including changing the weighting factor to apportion the CIT, providing GRT exemptions for certain business transactions and changing the CIT rate. The results of the study showed that allowing for a single-weighted sales factor in calculating the CIT would put New Mexico's effective tax rate on businesses at 2.0 percent, making it the most business-friendly state in the region.

The Ernst & Young study concluded that while the average tax burden for New Mexico businesses before incentives are factored in is more than twice other states' average rates, certain industries benefit tremendously from tax incentives, which reduce the effective tax rate significantly. However, the high CIT rate of 7.6 percent, the traditional method of calculating the CIT and the high incidence of GRT taxes, especially on the manufacturing industry, are almost certainly impeding economic growth, according to the study. New Mexico is somewhat competitive, depending on the industry and the individual situation of a business. If a business is not eligible for incentives, it faces a much higher effective tax rate than in other states.

After the study was completed, the legislature enacted GRT deductions for certain construction services and for inputs consumed during the manufacturing process. The new law significantly addressed the pyramiding aspect of the GRT for some industries, which makes New Mexico's effective tax burden ranking even better. Renewable energy equipment manufacturing and computer and electronics manufacturing now have the second-lowest effective tax rate in the region, compared to the highest and third-highest rankings prior to the legislation's enactment.

Questions and comments from committee members included the following.

- What happened to the solar manufacturing company that decided to locate in Arizona instead of New Mexico, which had cited the state's high tax burden as one reason for not choosing New Mexico? Mr. Anklam said that the company canceled its plans to locate a manufacturing plant in Arizona after the national economy soured.

- The state may be able to bring down some business tax rates by broadening the tax base. Mr. Anklam agreed and said that the state can no longer rely on the federal government to increase the state's economic activity. The only way to improve the economy, at least in the near future, is by increasing private-sector investment.

- Many states have been forced to change their tax structures and rates in the past two years to cope with declining revenues. New Mexico's rankings may improve more if the study were to use 2012 data.

There being no further business, the committee adjourned at 3:45 p.m.